



# Wake Up Call

**Connecticut's Fiscal and Economic Crisis  
and a Roadmap for Recovery and Reform**

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*Note: This report reflects solely the opinions and recommendations of Representative Tom Reynolds and is not intended to represent the views of the House Democratic Leadership or the House Democratic Caucus.*

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## **Connecticut's Fiscal and Economic Crisis and a Roadmap for Recovery and Reform**

**By State Representative Tom Reynolds  
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## **PART ONE: ORIGINS OF A CRISIS**

### **I. Introduction**

In March of 2009 I published *Crisis—A Terrible Thing to Waste: Connecticut's Budget Dilemma and the Opportunity for Reform*. The goal was to sound a “fiscal alarm” as the General Assembly convened the 2009 legislative session and to raise awareness of the depth of Connecticut’s fiscal crisis, and to build support for changing “business as usual.”

Most importantly, it proposed using the urgency of the crisis to advance an unprecedented agenda of reform. It offered a 10-point plan to return the state to fiscal stability, to bolster our economic recovery, and to enhance our capacity to tackle our greatest public policy challenges.

On a positive note, the FY 2010 – FY 2011 biennial budget adopted during that session protected most municipal aid which reduced the need to increase local property taxes, and preserved most programs critical to those citizens who bore the brunt of the Great Recession. These were no small achievements. During recessions state governments experience massive revenue declines, while the demand for social services sky rockets. The budget also made incremental progress in enhancing the progressivity of our state tax structure.

Despite these accomplishments, the structural issues at the heart of our fiscal crisis largely remain. As a result, we reinforced the “permanency” of our fiscal crisis setting up state leaders for an even greater crisis in the next biennium with even fewer viable strategies for addressing it.

As I travelled the state following the publication of my *Crisis* paper, the most common responses were: “Why didn’t anyone tell us the truth?” and “Don’t we elect you to do what’s right, regardless of whether or not the voters appreciate the mess we’re in?” Therefore, this paper seeks to continue the “truth-telling” and to encourage state leaders to embrace reforms and tough decisions, regardless of the political consequences.

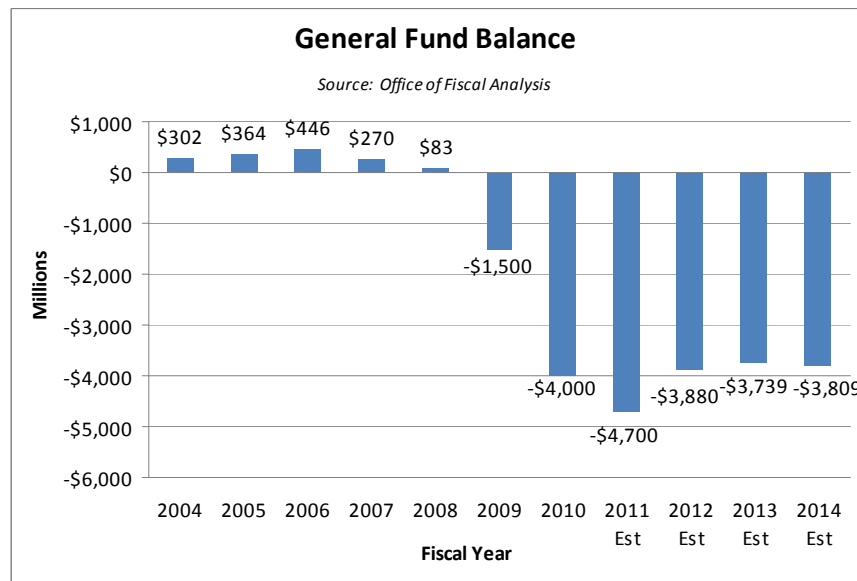
The 2011 session must be focused on launching long-term reforms that seek to correct the structural issues responsible for the state’s persistent deficits. However, budget reform alone will not be enough to fill the gaping hole in the next biennial budget. According to the Connecticut Center of Economic Analysis (CCEA) at UConn, cutting the budget by \$2 billion would “overwhelm private sector job growth, significantly raise the unemployment rate, reduce state revenues while raising public sector costs, and ultimately lead to losing population.”<sup>1</sup> Therefore, we must pursue a three-legged stool approach of budget and government reform, spending cuts, and revenue growth.

These realities are what inspire this “wake up call” to build public awareness of the scope and depth of the crisis and to cultivate grassroots and political support for this difficult, but necessary agenda. With a new Governor, the potential for change looks very real. This session the state can “turn the page” and start writing a new chapter of its own choosing.

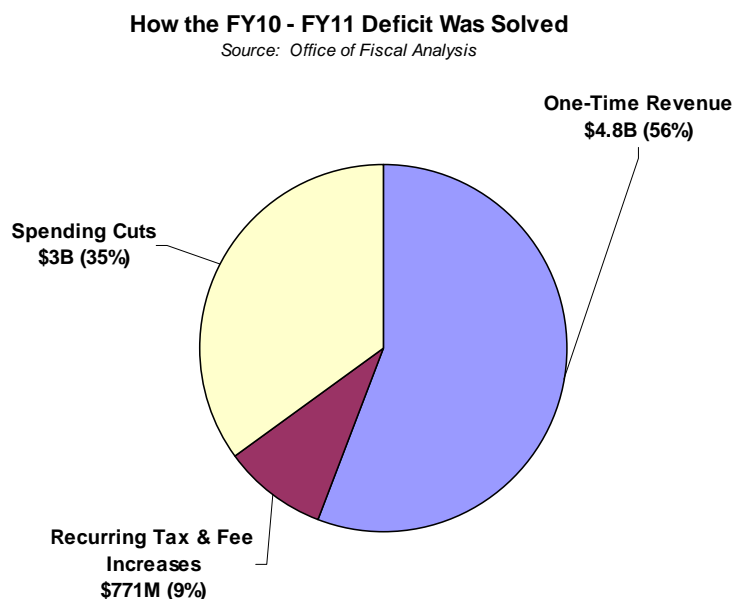
### III. Our Fiscal Crisis

#### 1. 2009 session

At the start of the 2009 session the state was confronted with a budget deficit of historic proportion. The FY 2010-FY 2011 deficit was nearly \$9 billion, an amount equal to one-quarter the entire biennial (two-year) budget.



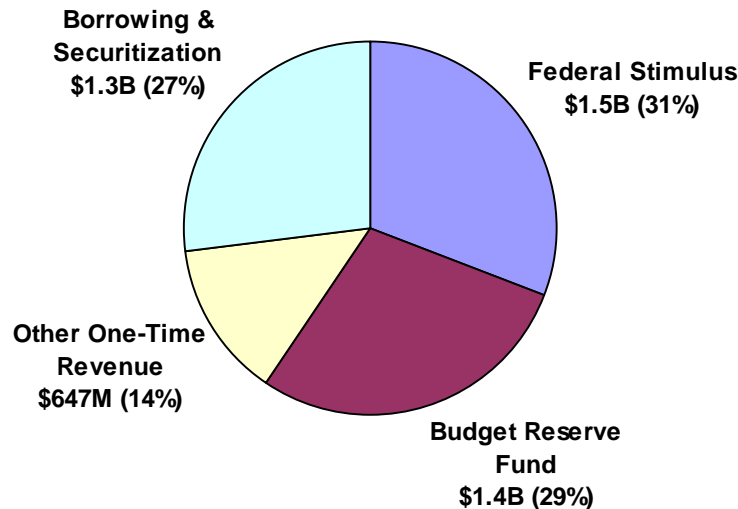
Over one-half of the deficit was closed using one-time revenues, one-third through spending reductions, and 9% through recurring tax and fee increases.<sup>2</sup> ***The manner in which the deficit was addressed poses an even greater dilemma for the next biennial budget.*** When one-time revenues are used to fund on-going programmatic expenses, it creates structural deficits in subsequent years. This one-time revenue consists primarily of federal stimulus funds, depletion of the Rainy Day Fund, borrowing, and borrowing against future revenue.



Dependence on some one-time revenues is unavoidable in a fiscal crisis. After all, the state was not going to forego federal funds; the Rainy Day Fund was intended for times like this, and draconian cuts would have exacerbated unemployment and other recessionary effects. However, this overdependence on one-time revenue is unprecedented compared to past recessions and has produced an untenable fiscal crisis for the coming biennium.

### One-Time Revenue in FY10/FY11 Budget

Source: Office of Fiscal Analysis



## 2. The Next Biennium

The Governor and legislature have convened the 2011 legislative session and must adopt the FY 2012 - FY 2013 biennial budget. The projected deficit at the start of session was \$7.3 billion, an amount equal to nearly one-fifth the two-year budget. The deficit for just FY 2012 is \$3.7 billion, three-quarters of which consists of a structural deficit resulting from one-time revenues utilized in FY 2011.<sup>3</sup>

### Explaining the FY 2012 Deficit

Source: Office of Fiscal Analysis, 10/2010

<b>Carryover FY 2011 Deficit to FY 2012</b>	<b>(\$83 million)</b>
<b>Revenue Issues</b>	
Loss of One-Time Revenue from FY 11 Budget	(\$2.1 billion)
Revenue Growth	<u>\$794 million</u>
<b>Total Revenue Impact</b>	<b>(\$1.54 billion)</b>
<b>Expenditure Issues</b>	
Growth in Spending	<u>(\$2 billion)</u>
<b>Total Expenditure Impact</b>	<b>(\$2.05 billion)</b>
<b>Resulting FY 2012 Deficit</b>	<b>(\$3.67 billion)</b>

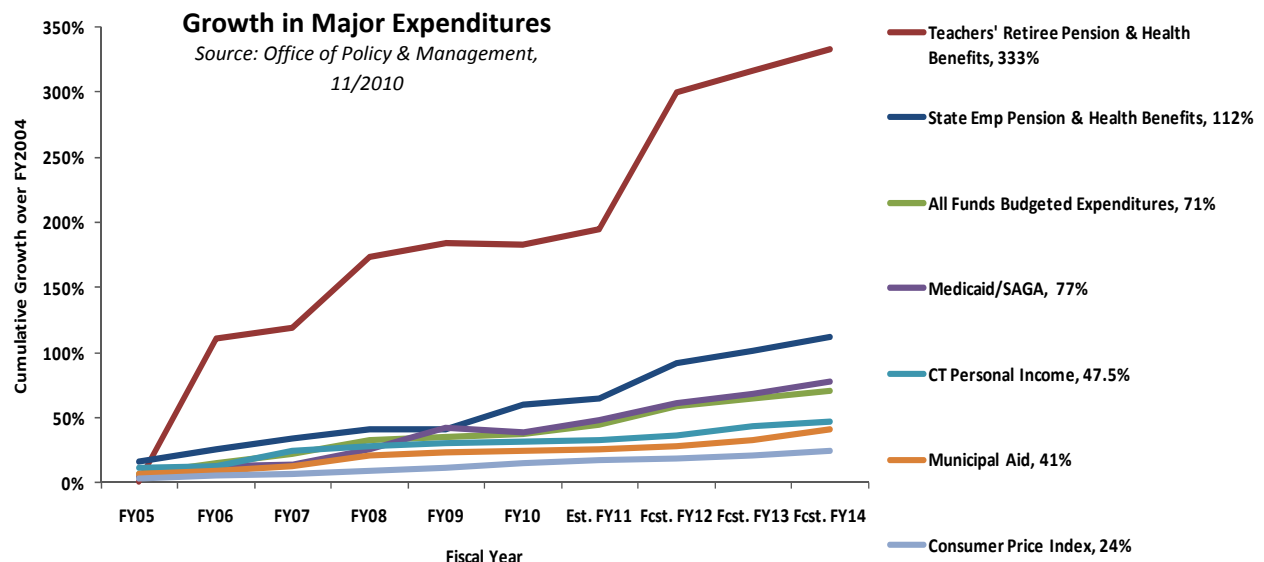
The options available to state leaders are few. The Rainy Day Fund and federal stimulus dollars are depleted. All fees have been increased. The “easy” cuts have been made. All “non-appropriated” funds have been swept. Union concessions have been negotiated. Borrowing capacity has been pressed to the limit, and tax increases on smokers and “the rich” have been adopted.

### 3. Revenue & Spending Trends

The state and national economies continue to show signs of recovery. However, recovery of the state’s traditional revenue streams has already been factored into deficit projections. The \$3.7 billion deficit projection for next year already assumes a net revenue increase of \$699 million (4.4%), including increases of \$548 million in income tax and \$114 million in sales tax.<sup>4</sup>

Revenue is exceeding expectations for the current year; however, even a doubling of projections in the revenue percentage increase for next year would still leave a deficit of \$3 billion. Therefore, ***the national recovery alone will not result in Connecticut returning to fiscal stability.***

Aggregate state spending has grown rapidly in recent decades. Between FY 2005 and FY 2014 the Consumer Price Index (CPI) is projected to increase 24% and Connecticut Personal Income by 48%. In the same time period total state spending is projected to grow by 71%.<sup>5</sup>



Medicaid, which provides health care to the elderly and poor, is projected to increase 77%.<sup>6</sup> The state dedicated over one-half of Medicaid dollars on long-term care in FY 2009, which was spent on just 40,000 clients or 1% of the population.<sup>7</sup>

Total state expenditures on health care across all agencies have grown to over \$7 billion in FY 2010, accounting for nearly 40% of all state spending.<sup>8</sup> ***Such investments are indeed worthy; however, the trend is unsustainable with no comprehensive plan for reigning in the cost of health care delivery.***

State agency energy costs have risen 135% from FY 2000 to FY 2008, with no comprehensive energy plan in place.<sup>9</sup> The Department of Social Services and Department of Children and Families budgets



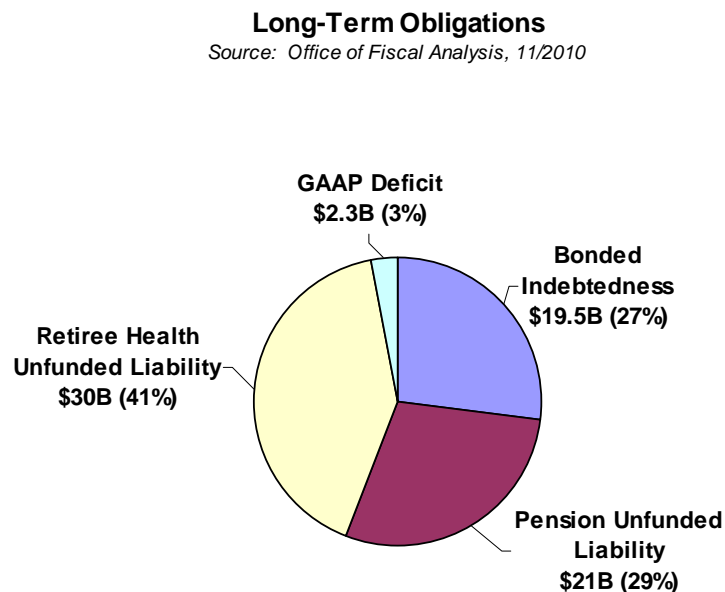
have grown dramatically to over \$5 billion and nearly \$1 billion per year, respectively, without commensurate improvements in the lives of the populations they serve.

Three-quarters of all General Fund spending in FY 2011 and the major drivers in projected deficits are limited to five areas: Medicaid, Wages & Benefits, Municipal Aid, Pensions & Retiree Healthcare, and Debt Service. Many of these investments were prudent and necessary at the time. However, ***the major drivers in the state budget are growing at rates that are simply unsustainable with no concrete plan for addressing the unchecked growth.***

#### 4. Long-Term Obligations

The state's long-term obligations include bonded indebtedness and unfunded liabilities for pensions and retiree healthcare. The state's long-term obligations now total an astonishing \$72 billion.<sup>10</sup>

Unfunded liabilities represent what the state is obligated to pay in the future in the form of pensions, health insurance, and other benefits for teachers and state employees. ***Connecticut is among the worst in the nation for the size of its unfunded liabilities.*** Our state employee pension liabilities are nearly \$12 billion. Compared to all other states, Connecticut is nearly dead last by funding only 44% of this obligation. The teacher pension liability is over \$9 billion and is funded at 61%.<sup>11</sup> Experts recommend a minimum pension funding level of 80%.

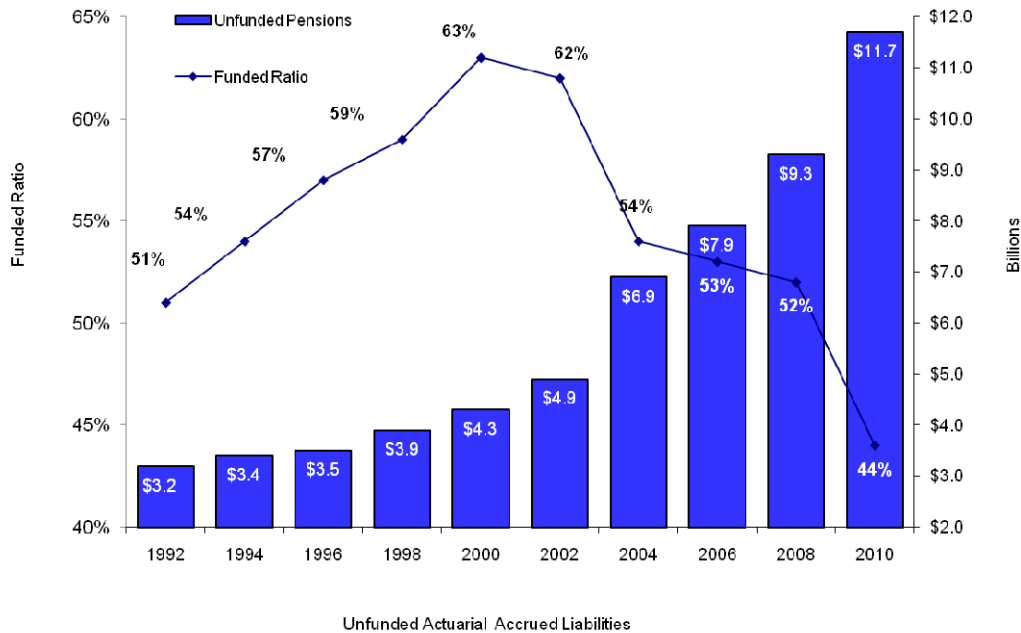


Our unfunded liability for Other Post-Employment Benefits (OPEB), health and life insurance for teacher and state employee retirees, is an astounding \$30 billion. The state is on an annual “pay as you go” system of meeting its OPEB obligations; therefore, ***Connecticut ranks nearly dead last among all states by funding 0% towards this liability.***<sup>12</sup>

Between FY 2005 and FY 2014 expenditures for state employee pension and health benefits are projected to increase 112%, and spending on teacher pensions and health benefits are expected to grow 333%.<sup>13</sup> There is no long-term plan for meeting these unsustainable trends.

### State Employee Pension Liabilities

Source: Office of Policy & Management, 6/30/2010



Connecticut's bonded indebtedness now exceeds \$19 billion—**ranking Connecticut fourth highest among all states in per capita state debt**. Even if adjusted for Connecticut's high personal income, the state still ranks eighth highest in the nation. In FY 2011 Connecticut will pay over \$2 billion in debt service or 11% of the state budget.<sup>14</sup>

### 5. Unemployment Compensation Fund

The state's Unemployment Compensation Fund (UCF) became insolvent in October 2009. It has continued to pay unemployment benefits by borrowing from the federal government. The need for continued borrowing is predicted to last until 2012 and is expected to total nearly \$1 billion. Final repayment of the loans is anticipated in 2014 using a combination of increased state and federal unemployment taxes.<sup>15</sup>

### 6. Bond Rating

Connecticut's bond rating, issued by credit rating agencies such as Moody's, Fitch, and Standard & Poor's, reflects the ability and willingness of the state to meet its financial obligations in full and on time.

In June 2010 Fitch downgraded Connecticut's bond rating to AA. Moody's and Fitch recalibrated the state's rating to Aa2 and AA+, respectively.<sup>16</sup> In the fall of 2010, Moody's revised the outlook on Connecticut's general obligation bonds from "stable" to "negative."<sup>17</sup> Only a handful of states have lower bond ratings than Connecticut.<sup>18</sup>

These rating decisions are a result of the state's choices in addressing its deficits in fiscal years, 2009, 2010 and 2011. Specifically, the agencies cited the state's reliance on one-time revenues and

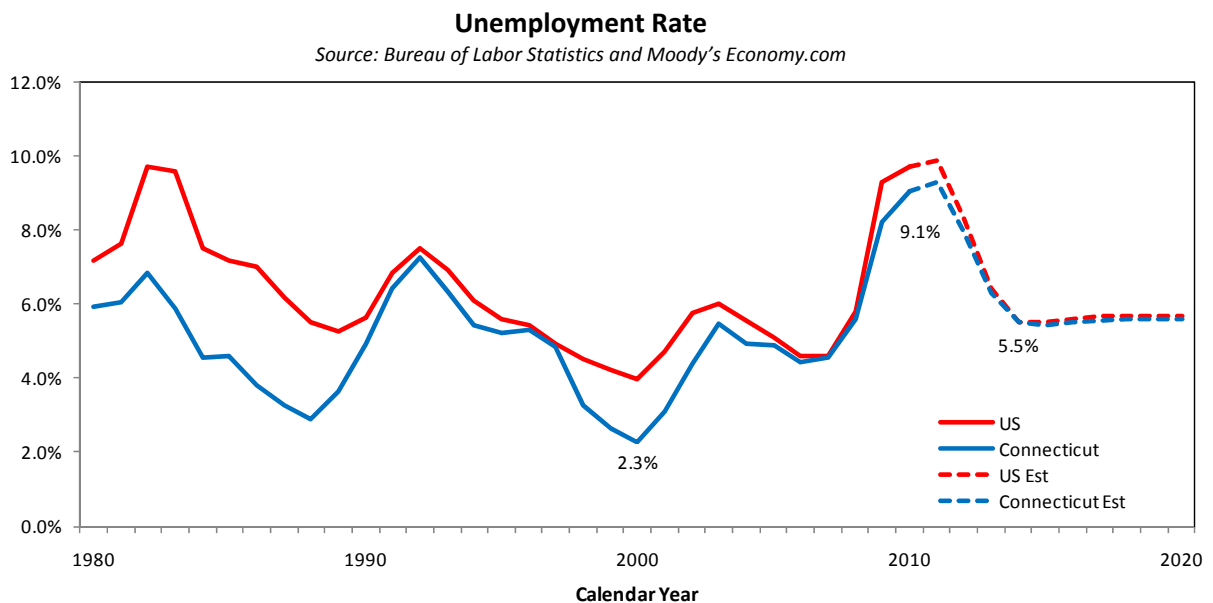
deficit financing, its significant unfunded pension and retiree healthcare liabilities, and its very high debt obligations.<sup>19</sup>

***A downgrading of the state's bond rating has serious implications for a state in fiscal crisis.***

According to the State Treasurer, if the state experiences a downgrade in its bond rating of “one or two notches” the state would pay as much as \$80 million in higher interest costs for bonds issued in FY 2010 alone. Furthermore, the Treasurer estimated the long-term impact could approach \$335 million in increased interest costs on the state's planned debt issuance over the next five years.<sup>20</sup>

#### IV. Our Economic Crisis

Connecticut's official unemployment rate continues to hover around 9%. However, according to the Connecticut Center for Economic Analysis (CCEA) there are nearly 400,000 working age adults who are no longer looking for work or working part-time but want to work more—putting the state's real unemployment closer to 20%.<sup>21</sup>



The state's record of job growth is among the worst in the nation. According to CCEA, ***in the last 20 years the state has only enjoyed net job creation in 11 months.*** Equally worrisome, CCEA concluded that during the same timeframe the state replaced high-skill, high-wage jobs with lower-skill, lower wage jobs.<sup>22</sup>

According to the *Connecticut Economic Digest*, between 1989 and 2009 “payroll employment in Connecticut is down more than 3.5% from where it was more than 20 years ago, giving us the ***worst job performance in the country.*** On this measure, Connecticut is below even Michigan (down 1.4%) and Rhode Island (down 2.1%) with the rest of the nation showing gains.”<sup>23</sup>

Connecticut has lost over 100,000 jobs during the Great Recession, and a forecast offered by CCEA projects that it may take as many as five years to regain those jobs if the status quo persists.<sup>24</sup> This jobs picture has a dramatic impact on state revenue and resulting deficits. Connecticut income tax revenue grew an average of 12% per year between FY 2004 and FY 2008, but it *fell* by 15% in FY

2009. In the 2002 recession, it only fell by 10%. The state's sales tax revenue fell by 7.3% in FY 2009, compared to 4% in the 2002 recession.<sup>25</sup>

Between 2000 and 2030 in Connecticut: The state's population is expected to grow only 8%, while the nation will grow by nearly one-third. The elderly, intense users of health and human services will increase by nearly 70%. The population between age 18 and 64—those who will pay for these increased services—will shrink, while the school age population will remain flat or decline.<sup>26</sup>

***Most Connecticut families are worse off now than at the start of the last recession.*** Connecticut was the only state in which real income of the poorest 20% of families *dropped* since the late 1980's. Our middle income families had the second smallest gain in average income in the same period. However, our wealthiest 20% experienced a 45% increase in average real income, the second highest increase in the country.<sup>27</sup>

#### **IV. Connecticut's Four "Deficits"**

The fiscal and economic crises previously described are a result of Connecticut's four "deficits" that have developed over two decades:

- 1. Our Governance Deficit**
- 2. Our Budget Deficit**
- 3. Our Economic Deficit**
- 4. Our Leadership Deficit**

In the long run only a ***comprehensive strategy that addresses all four "deficits"*** will return the state to fiscal stability, ensure our economic recovery, position the state to meet its long-term obligations, and provide the resources and disciplined systems necessary to solve our greatest public policy challenges.

In the short-term, given the severity of the state's near-term deficits and the magnitude of its long-term obligations, spending cuts alone will be unrealistic strategy to achieving fiscal and economic stabilization and jumpstarting economic growth. Therefore, we must embark on a ***three-legged stool approach: fiscal and government reform, spending reductions, and revenue growth.***

The following chapters offer recommendations for a new Governor and legislature to consider for how Connecticut's "deficits" can be addressed over the short- and long-term—starting today. These challenges are unprecedented, but the good news is that they are not insurmountable.

## PART TWO: AN AGENDA FOR RECOVERY AND REFORM

### V. Our Governance Deficit—A New Era of Planning, Performance and Accountability

#### 1. Long-Term Planning

It has been decades since Connecticut was truly committed to comprehensive long-term, strategic planning. Long-term planning is a “comprehensive plan for five years or more that outlines broad long-range goals and objectives for the state.”<sup>28</sup> Strategic planning “measures progress and assesses how state agencies are meeting these broad goals.”<sup>29</sup>

Long-term and *strategic planning represents a dynamic process of determining where we want to go as a state and how we will get there*, while measuring progress towards achieving desired outcomes.<sup>30</sup>

The Government Performance Project<sup>31</sup> grades the states on their performance and practices in management and governance. Connecticut is routinely rated one of the worst in the nation for comprehensive and long-term planning capabilities. In one study only two states had lower ratings than Connecticut.<sup>32</sup>

In a survey of 65 state agencies conducted by the Office of Policy & Management (OPM), only five agencies engaged in what could be described as strategic planning.<sup>33</sup> The plans that were in force existed as “silos” and were not developed in the context of a statewide vision and strategic plan and were not prepared in concert with agencies with overlapping public policy responsibilities.

When Connecticut engages in planning, it is:

- a. lacking a singular vision for the state,
- b. lacking overarching goals,
- c. compartmentalized, fragmented, single-agency, or focused on narrow policy areas,
- d. inadequately staffed and resourced,
- e. episodic and fails to endure with changes in leadership,
- f. advanced without adequate and quality data,
- g. lacking “teeth” to ensure implementation,
- h. largely irrelevant to the budget process, or
- i. fails to mandate performance measures to ensure accountability and results.<sup>34</sup>

The state budget has become Connecticut’s sole means of planning, but a budget is simply a short-term tool to advance long-term strategic goals. In Connecticut the budget is the goal in and of itself.

Through a disciplined and visionary planning process, led by the Governor and supported by the legislature, Connecticut can:

- a. pursue a future of its own choosing,
- b. avoid the cost of bad results,
- c. reduce its vulnerability to external economic forces,
- d. establish consensus on funding priorities and make uninterrupted progress on the most important issues,
- e. encourage coordination between agencies on shared policy objectives,
- f. increase efficiency of spending and reduce duplication of services,

- g. link budgets to outcomes and ensure accountability for results,
- h. improve transparency and public confidence in government, and
- i. in times of deficit provide a tool for informed, strategic budget cuts, rather than uninformed and arbitrary across-the-board cuts.<sup>35</sup>

**We must** establish in law a statewide long-term and strategic planning process. The process must consist of best practices proposed by the non-partisan Program Review & Investigations Committee and the Council of State Governments *State Governance Transformation* initiative.

**We must** establish an oversight body, the *Council on Connecticut's Future*, to oversee the planning process. The Council would be chaired by the Governor, provide for gubernatorial and legislative appointments, and located in the Office of Policy & Management in a reconstituted Division of Planning & Government Performance.

**We must** give the Governor and Council unprecedented authority to articulate a vision for the state, to establish overarching goals consistent with that vision, to require agencies to develop strategic plans and budgets aligned with the state plan, and to make agency budgets dependent on compliance with planning obligations and established performance and accountability measures.

## 2. Performance & Accountability

Connecticut largely uses “cost-based” budgeting in which agencies submit a modified version of the current year’s budget and then lobby the Governor and legislature for a percentage increase. There is no requirement that commissioners systematically justify their current funding let alone future increases, and there is inadequate data capacity to conduct such due diligence.

Therefore, the legislature is left to choose between approving unjustified budget growth, cutting services arbitrarily, raising taxes, or some combination of these poor choices. This leads to uninformed debate over what to cut, what to tax and what percentage to increase the budget—avoiding the truly necessary and more strategic decisions.

According to a report produced by the legislature’s non-partisan Program Review & Investigations Committee, “there is no link, analysis, or evaluation of how each agency’s spending is tied to overall state policy or how well each agency is performing in reaching any statewide goals.”<sup>36</sup> This makes it very difficult to build public and political support for major investments in key public policy areas.

If Connecticut adopted Results-Based Accountability (RBA) we could begin to change for the better. Use of RBA in the context of a long-term, strategic plan would drive decision-making and justify investments and reductions. Such a system would allow Connecticut to prioritize its spending by investing in “high-value” spending and reducing “low-value” spending.<sup>37</sup>

**Connecticut must “budget for outcomes.”** How much revenue will we have? What outcomes matter most? How much should we spend to achieve each outcome? How can we best deliver each outcome? How will we demand accountability in performance? How will we measure progress, success or failure?

Without such data, how will the Governor and legislature make informed decisions about what to cut to resolve the deficit? If compliance with RBA principles was mandated for all agencies, we

would know which programs were working and which were failing to deliver the intended results. Instead of across the board spending cuts which are uninformed and arbitrary to “share the pain,” our reductions could be strategic to avoid areas with a high return on the state’s investment.

Debating the false choice between reducing spending and increasing taxes rarely leads to concrete change. RBA would bring logic and accountability to state budgets. It is an innovative model of planning, budgeting and monitoring that ensures government spending is efficient, effective, transparent, and accountable to results.

**We must** adopt a multi-year implementation plan to require state agencies to adhere to RBA principles, beginning with programs that are major cost drivers in the budget.

**We must** require all programs to have clearly articulated goals for the populations they serve, specific outcomes to be achieved, established benchmarks to measure progress towards the outcomes, and overall program performance measures.

**We must** charge the Governor, through a Chief Performance Officer in a re-chartered OPM Division of Planning & Government Performance, with advancing this initiative.

**We must** enhance the state’s capacity for data collection and analysis, and utilize the untapped potential of the state’s existing technological capacity for linking spending with outcomes.

### **3. Accounting Methods**

Connecticut does not abide by Generally Accepted Accounting Principles (GAAP) established by the Governmental Accounting Standards Board (GASB). GASB is an independent organization that establishes standards of accounting for state and local governments, collectively referred to as GAAP.

GAAP standards are used by the state for federal auditing purposes, bond issuances, and selected reports by the State Comptroller. However, the standards are not honored in the budget process. Connecticut develops budgets and prepares financial statements based on a modified cash basis, rather than a modified accrual basis required by GAAP. This leads to a less than honest and transparent system of reporting the state’s true financial state and future obligations. It also leaves the state budget vulnerable to manipulation.

According to the Government Performance Project, “(Connecticut’s) unusual way of keeping its books has made it somewhat easier to hide from the truth. Connecticut accounts for ... revenue streams as quickly as possible, while taking the opposite approach with its expenses.”<sup>38</sup> Abiding by GAAP would likely reveal millions of dollars in artificially buoyed funds.<sup>39</sup>

***GAAP is necessary to enhance public trust, accountability and transparency.*** Businesses and municipalities are required to abide by these principles. State government should hold itself to the same high standard. Conversion to GAAP was mandated in state law in 1993, but has been repeatedly postponed by the Governor and legislature because of the impact on the budget. GAAP would, in essence, decrease any year-end surplus and increase any deficit.

**We must** abide by GAAP for the coming biennial budget and adopt a multi-year plan to address the cumulative GAAP deficit.

#### **4. Legislative Oversight**

The magnitude of the challenges described in this report and the political leadership required to address them will require that the legislature enhance its effectiveness and oversight role. Great progress has been made over the last two decades to professionalize our part-time, “citizen” legislature. This includes the construction of the Legislative Office Building and the development of professional, non-partisan offices for bill drafting, fiscal analysis, and policy research.

However, the complexity of our most vexing public policy issues and the fundamental and structural reforms necessary to address Connecticut’s four “deficits” will require a legislature that is more engaged outside the limited window of the legislative session (five months in odd years; three months in even years). This should begin with the Appropriations and Finance Committees meeting regularly throughout the year.

During session these committees are understandably focused on short-term objectives: budget review and adoption, public hearings, and action on pending legislation. There is little opportunity to conduct informational hearings, policy briefings, and in-depth discussions of important issues outside the pressure and narrow focus of a deadline-driven session. Meetings outside of regular session could focus on long-term, strategic issues, including the ones described in this paper, and analysis of policy trends and reform models in other states, and development of legislation for future sessions.

#### **VI. Our Budget Deficit—A Blueprint for Reform**

***Connecticut must fundamentally change the way state government works*** and embark on a new era of reform to make state government more efficient, effective and accountable. The following agenda proposes reforms in seven major areas

1. Cost Drivers
2. Debt Burden
3. Unfunded Liabilities
4. Spending Cap
5. Tax Policy
6. Tax Expenditures
7. Budget Reserve Fund

##### **1. Cost Drivers**

Three-quarters of all General Fund spending in FY 2011 and the major drivers in projected deficits are limited to five areas. Therefore, any serious discussion of reducing the size of state government and closing structural budget deficits must be focused disproportionately on the following areas:

1. Medicaid—\$4.3 billion (23.6%)<sup>40</sup>
2. Wages & Benefits—\$3.1 billion (17%)
3. Municipal Aid—\$2.8 billion (15.4%)
4. Debt Service—\$2 billion (11%)<sup>41</sup>
5. Pensions & Retiree Healthcare—\$1.7 billion (9.3%)



**We must** accelerate the “Money Follows the Person” initiative to shift patients from expensive, skilled nursing facilities to cheaper and more appropriate home and community-based programs. Connecticut is third in the nation in per-capita use of nursing homes, rather than more affordable alternatives.<sup>42</sup> One study projects a potential savings of \$1 billion by 2025.<sup>43</sup>

**We must** implement patient-centered “medical homes” for every member of state coverage plans, implement Primary Care Case Management for HUSKY patients, recover overpayments to HUSKY HMO’s, move HUSKY to self-insurance, and rebid HUSKY and state health care purchasing regularly.<sup>44</sup>

**We must** implement selected recommendations of Sustinet, the state’s long-planned health insurance plan that will lead to savings.

**We must** adopt legislation allowing for healthcare “pooling” which would allow municipalities, small businesses, and not-for-profits to access the state health insurance program.

**We must** implement the recommendations of the non-partisan Program Review & Investigations Committee on e-government to achieve savings in service delivery.

**We must** conduct independent performance reviews of major state programs on a regular schedule, possibly through the Auditors of Public Accounts. These reviews would evaluate programs’ alignment with the state’s strategic plan and their success in meeting performance benchmarks according to Results-Based Accountability (RBA).

**We must** build a more diverse and complimentary strategy for providing human services in a more cost-effective manner by bringing together government, community providers, and philanthropic communities and implementing selected recommendations of the Commission on Non-Profit Health and Human Services.

**We must** cease incentivizing inefficient delivery of municipal services. State aid should incentivize regionalization and shared services, not reward towns that wish to pay a premium for small, inefficient governmental infrastructures.

## **2. Debt Burden**

The Connecticut Constitution requires that Connecticut have a balanced budget. Unlike the federal government, the state cannot ignore a deficit. However, this does not mean that we cannot—like the federal government—take on crippling debt.

In 1988, 5.3% of state spending was spent on debt service, but this year debt service represents 11% or \$2 billion.<sup>45</sup> If the same percentage of the budget went to paying off debt now as in FY 1990, there would be \$1 billion more today to address deficits, pay off debt, reduce unfunded liabilities, or make strategic program investments.<sup>46</sup>

School construction grants typically account for at least one-half of total bonding in a given fiscal year. The generosity of the program relative to other states and the program’s lack of accountability and controls has led to crushing debt for state taxpayers.

**We must** prohibit the use of borrowing for ongoing operating expenses.

**We must** develop a long-term, statewide capital improvement plan that is aligned with the state's long-term, strategic plan proposed earlier.

**We must** evaluate and approve bonding requests based solely on how they will advance the strategic goals and most critical needs identified in a new state strategic plan.

**We must** reform the school construction reimbursement formula to rebalance local-state financial obligations, to reduce state bonding and subsequent debt service, and to give the Governor more authority over this type of bonding.

**We must** cease the practice of bonding small and local projects that are more appropriately funded through the appropriations process.

### **3. Unfunded Liabilities**

The legacy of the state's history of underfunding its pension and Other Post-Employment Benefits (OPEB) will lead to dramatic increases in annual contributions and may lead to lower bond ratings, greater interest on debt, higher taxes, and less discretionary funding for strategic investments. When benefit levels are negotiated Governors and the unions and ratified by legislatures, then the state has a moral obligation to fund its liabilities. Unfunded liabilities represent claims against future state revenues. ***Every dollar not paid towards the state's actuarial costs today will cost taxpayers \$2-\$3 in the future.***<sup>47</sup>

The state greatly expanded its liabilities by deferring pension contributions, over \$300 million in the last three years, as a part of union concessions and deficit reduction.<sup>48</sup> The state's recent Retirement Incentive Program will also add \$117 million to the pension liability in next year.<sup>49</sup>

**We must** fully fund the actuarially required contribution (ARC) to the state employee and teacher pension funds, develop a long-term plan to reduce the unfunded liability and achieve a funding level of 80%.

**We must** increase annual contributions to the OPEB Trust Fund for retiree health insurance obligations and adopt a 25-year plan for addressing the unfunded liability.

**We must** avoid early retirement incentive programs which exacerbate the pension liabilities.

**We must** honor state law directing budget surpluses to the Budget Reserve Fund (BRF), debt reduction, and unfunded liabilities and adopt new legislation requiring mid-year sweeps of projected surplus to be deposited into the BRF.

**We must** continue current dialogue with state employee unions on strategies to address unfunded liabilities.

**We must** adopt health care cost containment strategies discussed earlier to reduce OPEB liabilities.

#### 4. Spending Cap

The Connecticut General Assembly adopted spending cap legislation in 1991 to garner political support necessary to enact the income tax. The cap allows state spending to grow from one year to the next by the greater of a five-year average growth in state personal income or the percentage increase in inflation during the preceding year.

The spending cap applies to all appropriations, except debt service payments, grants to distressed municipalities, first year expenditures on federal or court mandates, and transfers of unappropriated surplus to the Rainy Day Fund, state employee retirement fund, or debt service. The cap may be exceeded with an emergency declaration of the Governor and approval of at least 60% of members of both the House and Senate.

The voters approved a Constitutional amendment in 1992 adopting a spending cap and directing the legislature to define the key terms and definitions governing the cap. However, the legislature has never codified definitions. Therefore, the statutory cap passed in 1991 contains the operative language defining how the cap will be calculated and implemented, which contributes greatly to the cap's structural weaknesses.

A spending cap can be good public policy; however, ***Connecticut's cap is poorly designed, increasingly unworkable, and routinely ignored.*** For example, the state's previous two governors issued "emergency" declarations, supported by the legislature, to exceed the cap in 8 of 11 fiscal years during their tenures for a total of \$3.6 billion of spending above the cap.

What's more, the spending cap's flaws have resulted in additional "spending" through budget techniques that circumvent statutory restrictions, while giving the appearance of a "cap" on spending—leading to greater taxpayer obligations over the long-run. For example, the cap has increased our dependence on borrowing for small projects and ongoing expenses, since debt service payments are exempt from the cap—costing taxpayers much more in the long-run.

The current cap design encourages "outside the cap" spending through the use of revenue intercepts that restrict specific revenues to non-lapsing funds that provide funding for specific programs without the need for annual appropriations (e.g. Citizen's Election Fund).<sup>50</sup> In the FY 2007 budget, nearly \$2 billion was in special, non-appropriated funds, nearly \$1 billion more than in FY 1997.<sup>51</sup> Ironically, the spending cap has resulted in much less of the state's spending being subjected to the scrutiny of the appropriations process, thus reducing transparency and accountability.

The existing cap encourages a shift from appropriated grants and programs, particularly for economic development, to tax credits, exemptions and deductions—tax expenditures that do not count as appropriations and are not annually reviewed or publicly scrutinized.

Our spending cap discourages the state from claiming all federal funds to which it is entitled, since most federal funds count under the cap. Only 16% of Connecticut's state and local revenue comes from the federal government—the third lowest share among all states. Connecticut's relative wealth is a factor in our share of federal funds; however, the state consistently leaves federal funds "on the table."

**We must** direct the non-partisan Program Review & Investigations Committee to conduct a study of the impacts of the spending cap and its effectiveness in achieving its original purposes and to make recommendations for reform.

**We must** adopt legislation defining the key terms and definitions governing the cap, as required by the State Constitution.

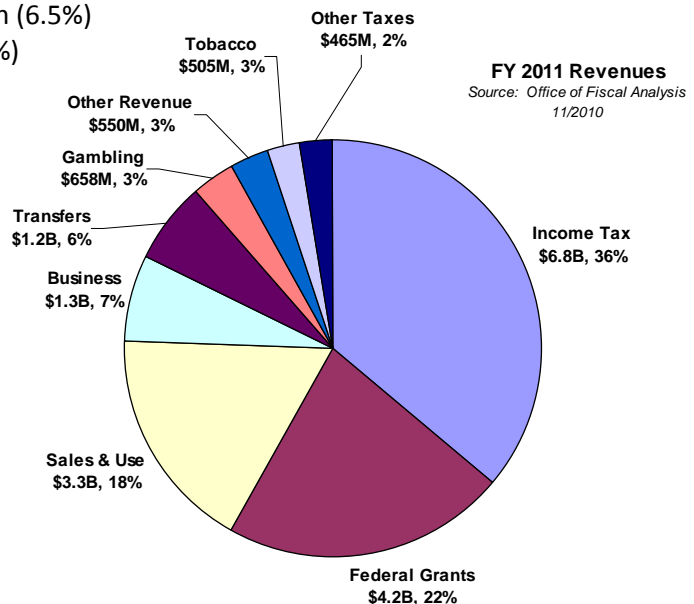
**We must** adopt reforms to cease the practice of routinely exceeding the cap, increasing borrowing, leaving federal funds on the table, and using budget gimmicks to spend outside the cap.

#### 4. Tax Policy

Connecticut's tax system is antiquated and has failed to keep pace with the dramatic shifts in the economy. We need a ***tax system that is modern, aligned with the new economy, less volatile, more reliable, more equitable and fair, and far less dependent on the property tax.***

The top five revenue sources in FY 2011, accounting for 86% of total revenue, are:<sup>52</sup>

1. Personal Income Tax—\$6.8 billion (36%)
2. Federal Grants—\$4.2 billion (22%)
3. Sales & Use Tax—\$3.3 billion (18%)
4. Businesses Taxes—\$1.3 billion (6.5%)
5. Gambling—\$658 million (3.5%)



**We must** enact comprehensive tax reform to conform to principles of a high-quality state revenue system outlined by the National Conference of State Legislatures (NCSL):

- a. Aligned with state's long-term, strategic goals;
- b. Ensures stability, reliability and sufficiency;
- c. Improves equity and fairness and minimizes regressivity;
- d. Diversifies and balances revenue streams;
- e. Complements local government revenue systems;
- f. Responsive to interstate and international competition;
- g. Transparent and accountable to taxpayers;
- h. Broadens the tax base to reduce tax rates.

**We must** conduct and act on the findings of a Tax Incidence Analysis to assess its conformance with the above NCSL principles and to align the revenue infrastructure with the state’s new long-term, strategic plan proposed earlier.

**We must** enhance the progressivity of our income tax, while remaining competitive with neighboring states.

**We must** modernize the sales tax to reflect our changing economy, which continues to move from product-based to service-based, from local businesses to multi-state/national corporations, and from local stores to on-line sales. Sales tax exemptions that lack a compelling public policy justification should be eliminated.

**We must** reduce our dependence on the property tax. Local property taxes in Connecticut produce more revenue than any other tax—local or state. Connecticut ranks second—at 31%—among all states in the share of state and local revenue coming from the property tax.<sup>53</sup> This results in an unfair burden on low and middle income families and on businesses and incentivizes towns to make poor economic development decisions. As a result of comprehensive tax reform, a rebalancing can occur between local vs. state tax obligations.

## **5. Tax Expenditures**

Tax expenditures are tax credits, exemptions, and deductions that give preferential treatment to taxpayers through the tax code. Many tax expenditures support worthy public policy goals. However, rarely do these tax policies get re-examined in light of changing economic conditions and evolving public policy needs, and most never receive a routine assessment of their strategic value to the state relative to the revenue lost.

Total “spending” through tax expenditures will exceed \$5.4 billion in FY 2011.<sup>54</sup> If tax benefits are to be offered, resulting in an erosion of the tax base, there must be greater accountability and transparency. Dependence on tax expenditures has grown dramatically, often as a means of “spending” while avoiding the spending cap.

The number of credits against the corporation tax has increased from 11 when the cap was passed to 29 today. The amount claimed has increased nearly 100-fold.<sup>55</sup> Of the 116 exemptions to the sales tax, nearly 50 (42%) were added since the spending cap was adopted. Nearly a quarter of state “spending” is now through preferential tax expenditures.<sup>56</sup>

**We must** subject all tax expenditures to a schedule of cost-benefit analysis and sustain only those that advance critical interests as articulated in the state’s strategic plan.

**We must** make the distribution of tax benefits more transparent and publicly reported and make more tax expenditures subject to caps on the total amount that may be claimed each year.

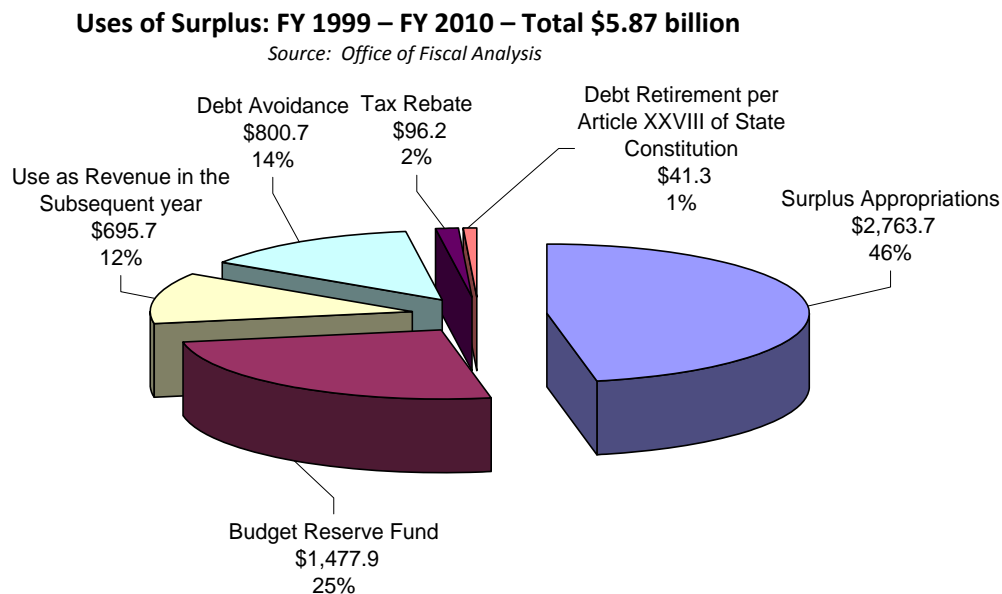
## 7. Budget Reserve Fund

The state's Budget Reserve Fund (BRF), or "Rainy Day Fund," exists to help the state endure economic downturns and avoid reacting to them in ways that may exacerbate the decline. State law allows the BRF to equal up to 10% of net General Fund appropriations.

The state has never met this statutory threshold because surplus is more often used to fund ongoing programs. For example, \$290 million in FY 2007 surplus, \$480 million in unspent FY 2008 funds and \$16 million of FY 2008 transferred revenues funded ongoing expenses in the FY 2009 budget. As a result, nearly \$800 million of the original FY 2010 – FY 2011 structural deficit was a result of this practice.<sup>57</sup>

Between FY 1999 and FY 2010 the state enjoyed cumulative surpluses of \$5.9 billion. However, only one-quarter of it was deposited into the BRF, only 14% to reduce debt, 2% to send rebates to taxpayers, and none of it for unfunded liabilities. However, 58% was used to fund ongoing operating expenses.<sup>58</sup>

**We must** mandate by law that all surplus funds be used to build the Rainy Day Fund and, when the statutory threshold is reached, all remaining surplus be used to reduce unfunded liabilities or debt.



**We must** amend state law to allow the Budget Reserve Fund to grow to an amount equal to 15% of net General Fund appropriations.

**We must** require mid-year sweeps of projected surpluses to the Rainy Day Fund to preclude expenditure of surplus on future operating expenses.

## VII. Our Economic Deficit—A Roadmap for Recovery

If Connecticut is to overcome its fiscal and economic crises, the state must develop a visionary economic strategic plan. The business community has long advocated for investments in

Connecticut's infrastructure, most notably transportation. The state's energy costs are also among the highest in the nation. The importance of progress in these areas is well understood and must be pursued. This section focuses on equally important strategies that are far less appreciated and have not been advanced.

## **1. The New Economy**

If Connecticut is to grow and prosper economically, it must emerge as a leader in the "New Economy"—one that is "global, entrepreneurial, innovation-based, technology-focused, and knowledge-based."<sup>59</sup>

According to the *2010 State New Economy Index* published by the Information Technology & Innovation Foundation, innovation leads to job growth in three ways:

1. Innovation gives firms a "head start" in launching new services and products, which expands exports. Growth in exports creates twice as many jobs as the same amount of sales domestically.
2. Innovation's "expansionary effects" lead to employment growth in supporting industries, such as the ripple effect that occurred in information technology during the 1990's.
3. Innovation leads to higher productivity, which results in higher wages and lower prices.<sup>60</sup>

## **2. A New Model of Economic Development**

For decades Connecticut has clung to an outdated model of economic development, which depends on directing financial assistance to companies with state agencies acting as lenders. Thus state leaders have focused primarily on managing grant and loan programs and negotiating incentives to retain or attract large businesses, which has failed to result in uninterrupted job growth.

If Connecticut is to emerge as a world leader in the New Economy, we need a new model of economic development that focuses instead on long-term advancement of state assets—most notably its human capital, through education and training, through improvement of physical infrastructure, and by building a state economy around innovation.<sup>61</sup>

When Pfizer announced its decision to transfer 450 highly paid, highly educated employees from Connecticut to Cambridge, MA (a high-cost, high-tax city and state) the company did not cite taxes, regulations or the cost of doing business in Connecticut. It cited its need to be close to "key hubs for science and technology," "leading biomedical research institutions," and a "deep, energized talent base."<sup>62</sup> Connecticut—more than any other state—has the historic and natural strengths and the untapped capacity to be just as attractive to the current and future "Pfizers" of the world.

Connecticut cannot compete nationally or globally on a low-cost/low-tax strategy, although we should not exacerbate these factors. We *can* compete in offering the most educated, productive and highly trained workforce capable of competing for knowledge-based jobs to discover, develop and commercialize the new and innovative products and technologies of the New Economy.

This new model requires the state to provide an extraordinary level of support (particularly to small business) to increase access to capital, to respond effectively to changing markets, to commercialize new ventures, and to build collaborations between public, private, not-for-profit, and academic institutions to cultivate fertile ground for success in the New Economy.<sup>63</sup>

Connecticut has failed to allocate state personnel and resources to provide this support. The total salary budget for the state Department of Economic & Community Development for FY 2011 is \$6 million. However, ***only \$856,000 (14%) was expended on staffing of economic development programs.***<sup>64</sup>

### **3. Workforce for the 21<sup>st</sup> Century**

The development of the state's New Economy will require a system of education and training that is preeminent in the world. The New Economy demands a workforce that is highly educated, trained, and entrepreneurial. A high cost, high tax state can prosper, but only if it provides a workforce and culture of innovation that is second to none.

Connecticut suffers from the greatest academic achievement gap in the nation. Not only do our poor children perform dramatically worse than our non-poor students, but our poor children perform worse than poor children in many other states.

The state's achievement gap statistics are alarming:

- The academic achievement gap between poor and non-poor students is 3.3 grade levels in reading.<sup>65</sup>
- Average Connecticut Mastery Test (CMT) scores reflect a 40 point gap between poor and non-poor students.
- Only 12% of African-American 4<sup>th</sup> graders are "proficient" in reading, compared to 56% of white students.
- Only 6% of urban 10<sup>th</sup> graders passed all 4 sections of Connecticut Academic Performance Test (CAPT).
- The drop out rate at some urban high schools is as high as 68%.<sup>66</sup>

What does this have to do with our capacity to recover economically? Nearly one-half of our future workforce will come from our urban centers. If we are to offer a labor market for the 21<sup>st</sup> Century to prosper in the New Economy, we must raise the academic performance of our poor children. ***Failure to address education inequalities now will ensure an unacceptable baseline for future economic growth.***

According to a report by McKinsey & Company, there is a negative economic impact from a persistent achievement gap: "If the United States had in recent years closed the gap between its educational achievement levels and those of better performing nations..., GDP in 2008 could have been \$1.3 trillion to \$2.3 trillion higher. This represents 9% to 16% of GDP."<sup>67</sup>

The report further states "the persistence of these educational achievement gaps imposes on the United States the economic equivalent of a permanent national recession. The recurring annual economic cost of the international achievement gap is substantially larger than the deep recession the United States is currently experiencing."<sup>68</sup>

**We must** raise standards and expectations for all students, since even our most academically gifted students are failing to compete with those of other developed nations.



**We must** establish the Education & Workforce Cabinet to coordinate cross-agency collaboration in advancing the state's strategic goals in education and workforce development.

**We must** consolidate and reform the state's governance and administrative system of elementary, secondary and higher education to redirect funds to teaching and learning.

**We must** fund universal pre-school in our poorest communities to enhance school readiness, to redirect funds for remedial education, and to permit parents to join the workforce or go to school.

**We must** accelerate and fully fund implementation of the secondary school reform adopted last year to ensure alignment of our graduates' knowledge and skills with the demands of the New Economy.

**We must** leverage the cost-effectiveness, proven track record and responsiveness of our community and technical college system to train the workforce of the 21<sup>st</sup> Century.

#### **4. Innovation Capitol of the World**

Connecticut invented vulcanized rubber, friction matches, the sewing machine, the steamboat, safety fuses, the mechanical calculator, portable typewriter, ice-making machine, can opener, tape measure, vacuum cleaner, cylindrical locks, and hundreds more.

In addition, Connecticut is credited with the first revolver, woolen mill, cotton gin, silk mill, nut and bolt factory, American warship, pay telephone, clock maker, insurance company, public art museum, color television, helicopter, submarine, artificial heart, and many more.

Connecticut's economic heritage is one of world-renowned innovation. Connecticut's "Yankee ingenuity" proved pivotal in winning American independence, the preservation of the Union during the Civil War, and two world wars—all fueling the nation's industrial growth. George Washington referred to Connecticut as the "arsenal of democracy."

As in the past, our economic prosperity in the future depends on our ability to reclaim our reputation as the Innovation Capitol of the World. According to the Information Technology & Innovation Foundation, Connecticut's "future is dependent on firms that see their future as tied to innovation, valued-added, and high productivity."<sup>69</sup> Often this will mean supporting new firms and cultivating existing small and medium-sized enterprises, but in all cases it will mean supporting innovation. After all, nearly all new jobs created nationally between 2008 and 2009 came from "young" firms.<sup>70</sup>

Connecticut's efforts to cultivate an innovation-centered economy should be focused on education and workforce development, entrepreneurial development, research support, technology transfer and commercialization, and manufacturing modernization. Connecticut's greatest potential lies in biotechnology, life sciences, biomedicine, stem cell research, clean energy, information technology, nanotechnology, and advanced manufacturing, such as defense, aerospace, and medical devices.

Connecticut has endured decades without a vision for its economic future or a comprehensive economic strategic plan, all but guaranteeing our persistent economic stagnation. Out of frustration, the legislature in 2007 directed the Governor to develop just such a plan. Following two

years of work and \$367,000 spent on consultants,<sup>71</sup> DECD released a 540-page document containing 66 recommendations.

Unlike a strategic plan envisioned by the legislature and adopted by most states, this document did not articulate a compelling vision for the state's economy, did not establish overarching goals for the state, did not prioritize the laundry list of recommendations, did not assign agencies or organizations with responsibilities and timelines, and did not identify funding sources.<sup>72</sup> As a result, the report was never embraced as a guiding economic plan by state leaders and has been "shelved."

The state has ample capacity to make the paradigm shifts proposed in this chapter. According to the Federal Reserve Bank of Boston, Connecticut is consistently rated first in the nation in "fiscal capacity."<sup>73</sup> The state is wealthy, small, nimble and well educated, thus it can move swiftly to capitalize on its strengths and mitigate its weaknesses.

Connecticut ranks in the top 10 nationally among many key economic indicators:

Per Capita Income	#1	Low Poverty Rate	#4
Finance and Insurance Jobs	#2	Scientists and Engineers	#5
Research and Development	#2	Initial Public Offerings (IPO)	#5
High Speed Connectivity	#2	Manufacturing Productivity	#6
Education Investment Per Child	#2	Health Insured Population	#7
Advanced Degrees	#3	Healthy Residents	#7
Energy Efficiency	#3	Patents	#8
Production per Energy Unit	#3	Exports	#8
Foreign Direct Investment	#4	Worldwide Productivity	#8
Total State Production	#4		

*Source: 2010-11 Connecticut Economic Review, published by Northeast Utilities Companies*

By 2018 Connecticut is expected to lead the nation in job openings requiring a master's degree or better.<sup>74</sup> In the past 20 years Connecticut experienced productivity growth well above the national average.<sup>75</sup>

In a global economy, exports are a leading indicator of economic strength and Connecticut is poised to lead the nation. Both job creation from exports and investment by foreign companies in Connecticut has consistently outpaced the nation.<sup>76</sup>

Connecticut ranks 5<sup>th</sup> in the nation on the *2010 State New Economy Index*,<sup>77</sup> which examines the degree to which state economies are global, entrepreneurial, innovation-based, technology-focused, and knowledge-based. It is interesting to note that the states ranked above Connecticut are also high-cost/high-tax states.

**We must** consolidate dozens of departments and programs with responsibility for economic development, including the Department of Economic & Community Development, Department of

Culture & Tourism, Workforce Competitiveness Board, Connecticut Development Authority, and Connecticut Innovations, under a new Department of Commerce.

**We must** establish a public, private, not-for-profit, and academic “Economic Prosperity Council” that will collaborate on implementing a new economic strategic plan with an emphasis on education and workforce development and a state economy centered on innovation.

**We must** conduct a review of all economic development-related tax expenditures to realign tax incentives for small and medium businesses focused on innovation.

**We must** provide technical assistance to small and medium businesses in commercialization and technology transfer, which is the movement of technological and scientific advancements from research labs to the marketplace.

**We must** build on our historic strength in exports and as an attractive home for affiliates of international companies.

**We must** staff the pursuit of federal funds for research and development, particularly for university and state technology efforts.

**We must** build stronger collaborations with higher education, particularly Yale and UConn, to expand technology incubator programs.

**We must** increase state supported seed capital for small and medium-sized businesses focused on innovation and expand Connecticut’s “angel investor” tax credit.

**We must** provide robust staffing of the new state Office of Military Affairs (now one employee) to protect the U.S. Submarine Base, to attract future military missions to the state, and to grow the state’s defense and homeland security industries.

### **VIII. Our Leadership Deficit—A Challenge to Us All**

At the end of the day, none of these far reaching reforms or politically difficult decisions will be made without visionary and courageous leadership. If reforms are enacted this year they will not be sustained over the long-term without exemplary leadership. Leaders today must act with foresight, courage and honesty. We must aspire to meet the letter and spirit of our oaths of office, not the demands of our political self-interests or narrow special interests.

As President John F. Kennedy said in *Profiles in Courage*: “For without belittling the courage with which men have died, we should not forget those acts of courage with which men...have lived... A man does what he must - in spite of personal consequences, in spite of obstacles and dangers and pressures—and that is the basis of all human morality.”

However, each of us as citizens also bears responsibility. For in *Profiles in Courage* Kennedy also wrote: “In a democracy, every citizen, regardless of his interest in politics, ‘holds office’; every one of us is in a position of responsibility; and, in the final analysis, the kind of government we get depends upon how we fulfill those responsibilities. We, the people, are the boss, and we will get the kind of political leadership, be it good or bad, that we demand and deserve.”

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## End Notes

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- <sup>33</sup> *State Long-Term Planning*, Program Review and Investigations Committee, December 2007
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- <sup>39</sup> Government Performance Project, 2005
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